

MEMO# 4432

January 19, 1993

JANUARY 29 MEETING ON SHAREHOLDER BASIS REPORTING

11 See Institute Memorandum to Tax Members No. 5-93, Accounting/Treasurers Members No. 3-93, Closed-End Fund Members No. 4-93, Operations Members No. 4-93, Unit Investment Trust Members No. 4-93, International Members No. 4-93 and Transfer Agent Advisory Committee No. 3-93, dated January 13, 1993. January 19, 1993 TO: TAX COMMITTEE NO. 4-93 ACCOUNTING/TREASURERS COMMITTEE NO. 4-93 OPERATIONS COMMITTEE NO. 2-93 TRANSFER AGENT ADVISORY COMMITTEE NO. 6-93 RE: JANUARY 29 MEETING ON SHAREHOLDER BASIS REPORTING

As we previously informed you¹¹, the recently-introduced tax simplification legislation, H.R. 13, includes a provision that would require the reporting of average cost basis to certain shareholders in regulated investment companies ("RICs"). Although largely similar to the shareholder basis reporting legislation in previous bills, H.R. 13 would make changes to the basis adjustments required by the wash sale rule of section 1091 and the sales load basis deferral rule of section 852(f). The Internal Revenue Service also has raised certain issues in connection with the legislation. Given the importance of these proposed changes and the likelihood that tax legislation will be actively considered in the near future, a meeting devoted exclusively to shareholder basis reporting has been scheduled at the Institute for Friday, January 29 at 10:00 a.m. We urge those planning to attend to discuss the issues set forth below (and any others of concern) with others in their organizations so that all of the relevant viewpoints (tax, accounting, operations and marketing) are considered during the meeting. If you plan to attend this meeting, please call Theresa Brice at 202-955-3525 no later than Tuesday, January 26. Lunch will be served.

ISSUES TO BE CONSIDERED

1. Wash Sales (Code Section 1091) The Institute previously suggested that the wash sale rule not apply to a shareholder who redeems shares in a fund in December and purchases shares in the same fund in January if (1) the purchase is pursuant to a dividend reinvestment plan or other automatic purchase program or (2) the amount of the disallowed loss is \$25 or less. H.R. 13 would amend the wash sale rule to disregard shares purchased, pursuant to a dividend reinvestment program, after January 15 of the year following the year of the redemption, so long as (1) the shareholder entered into the dividend reinvestment program when the account was opened or, if later, at least 6 months before the date of redemption and (2) the redemption is from a "covered account" subject to average cost reporting.
2. Sales Load Basis Deferral (Code Section 852(f)) The Institute previously suggested that the sales load basis deferral rule not apply if a shareholder purchases and redeems shares in a fund ("Fund A") within 90 days and has not, by January 31 of the year following the year of the redemption, acquired shares in another Fund ("Fund B") at a reduced or waived load. H.R. 13 would amend section 852(f) to provide that a purchase and redemption of Fund A shares within 90 days and the acquisition of Fund B shares at a reduced or waived load, after

January 15 of the year following the year of redemption, have the following tax consequences: (1) the load would remain in the basis of the Fund A shares, (2) the amount of the load would be included in the shareholder's income as short-term capital gain in the year the shares in Fund B are acquired at a reduced load or waived load and (3) the amount included in income as short-term capital gain would be included in the basis of the Fund B shares. Among the alternative proposals to be considered on January 29 are those that would apply section 852(f) only if, (1) the acquisition of the Fund B shares occurs within 30 (or 45 or 90) days of the acquisition of the Fund A shares or (2) the acquisition of the Fund B shares occurs by February 15 (or 28) of the year following the year of the redemption.

3. Return of Capital H.R. 13 does not address the treatment of returns of capital on shareholder basis reports prepared by fiscal-year funds. The Institute is developing a regulatory return of capital proposal whereby funds would report all distributions through December 31 of a fiscal year as taxable, with any return of capital allocated ratably to distributions made during the remainder of the fiscal year. In those situations where a fund reasonably believes that its post-December 31 distributions (if any) will be insufficient to absorb the return of capital, the fund would be permitted to report to shareholders that a portion of its pre-December 31 distribution(s) is a return of capital. However, the fund would be subject to an additional penalty if the amount of the return of capital allocated to the pre-January 1 distribution(s) exceeded the amount that would have been reported had the return of capital been allocated ratably, following the close of the fund's fiscal year, to all of its fiscal-year distributions.

4. "Election In" For Pre-1995 Accounts The Institute has opposed any effort to require the reporting of average cost basis to shareholders whose accounts are opened before some prospective effective date. H.R. 13 reflects the Institute's concerns by applying only to accounts opened on or after January 1, 1995. The IRS is considering a proposal to permit shareholders with pre-1995 accounts to elect into the legislative reporting system by completing a detailed form that would provide the fund with all of the information necessary to compute the shareholder's average cost. It appears that funds would be obligated to accept such information from their shareholders and might even be required to provide shareholders with the information they would need to complete the form. It is uncertain whether funds would have any obligation to verify or otherwise review the information provided.

5. "Election In" for "Kicked Out" Post-1994 Accounts H. R. 13 provides that average cost reporting will not be required if a post-1994 account includes any shares acquired other than by purchase. The IRS is considering a proposal to permit a shareholder of such an account to provide the fund with the cost basis for the non-purchased shares so that cost basis reporting could continue to be provided for the account. As with the "election in" for pre-1995 accounts, it is uncertain whether funds would have any obligation to verify or otherwise review the information provided.

6. Prohibition on Use of Average Cost by Shareholders With Pre-1995 Accounts in Same Fund H.R. 13 provides that the computation of basis using average cost could be elected on an account-by-account basis. The IRS is considering a proposal to prohibit a shareholder from computing basis in a post-1994 account using average cost information provided by the fund, if the shareholder has a pre-1995 account in the same fund. It is possible that this proposal would be advanced as an additional incentive to encourage shareholders with pre-1995 accounts to elect into average cost reporting.

7. Additional "Election Out" of Average Cost Reporting H.R. 13 provides that a shareholder would be required to compute basis in a "covered account" using average cost unless an alternative method is elected on the tax return relating to the first redemption from the account. The IRS has expressed some interest in permitting shareholders who do not elect out of average cost in this manner to later elect out of the average cost method. * * * * *

We hope all interested groups will plan to send one or more representatives to the meeting on the 29th. Keith D. Lawson Associate Counsel - Tax

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